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IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-1616

BOGUE ELECTRIC MANUFACTURING CORPORATION, EDWARD P. SCHINMAN, ROBERT S. HERWIG, WILLIAM S. GUTTENBERG and MURRAY REIFFIN,

Petitioners,

—v.—

HERMAN L. ZELLER, IRWIN SMALL COMPANY, a Partnership, and BELCO POLLUTION CONTROL CORPORATION,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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—v.—

HERMAN L. ZELLER, IRWIN SMALL COMPANY, a Partnership, and BELCO POLLUTION CONTROL CORPORATION,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit which reversed the District Court's order and judgment granting summary judgment in favor of petitioners dismissing the complaint.

Citations to Opinions Below

The opinion of the District Court (Appendix B) is reported at 346 F. Supp. 651. The opinion of the Court of Appeals (Appendix A) has not yet been officially reported but has been reported at ¶93, 903 CCH Fed. Sec. L. Rep. [Current Binder].

Jurisdiction

The judgment of the Court of Appeals was entered on March 22, 1973. Petitioners' application for rehearing and application for rehearing in banc was denied by two orders dated April 24, 1973. The Court of Appeals stayed its mandate for 30 days by order dated May 8, 1973. The time for filing this petition expires on June 20, 1973.

The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1).

Questions Presented for Review

1. Whether under §28(a) of the Securities Exchange Act which limits recovery to "actual damages," an allegedly defrauded buyer, whose out of pocket loss has been fully recompensed may also recover such non-out of pocket items as lost profits, gains prevented and consequential damages.

2. Whether a measure of damages appropriate to state law claims of corporate mismanagement should be incorporated into the anti-fraud provisions of the federal securities laws.

Statutes and Federal Rules Involved

1. The Securities Exchange Act of 1934, §10b (15 U.S.C. §78j(b)) and Rule 10b-5 thereunder (17 C.F.R. §240.10b-5.

2. The Securities Exchange Act of 1934, §28(a) (15 U.S.C. §78bb(a)).

3. The Securities Act of 1933, §17(a) (15 U.S.C. §77q(a)).

The text of the foregoing provisions is set forth in Appendix C.

Statement of the Case

Detailed facts are set forth in the opinions of the courts below (Appendices A and B). Respondent Zeller, basing jurisdiction in the first instance on Section 27 of the Securities Exchange Act of 1934 (15 U.S.C. §78aa) and Section 22 of the Securities Act of 1933 (15 U.S.C. §77v), commenced this shareholder's derivative action on behalf of Belco Pollution Control Corp. ("Belco").

Named as defendants were Belco's parent corporation, petitioner Bogue Electric Manufacturing Corp. (hereafter "Bogue"); the members of the interlocking boards of directors of Belco and Bogue and their attorney; and Bogue's accountant, the respondent Irwin Small Company.

The complaint alleged violations of the anti-fraud provisions of the federal securities laws, to wit, §10b of the 1934 Act, Rule 10b-5 thereunder and §17(a) of the 1933 Act (the full text of those provisions is set forth in Appendix C).

The heart of Zeller's claim is corporate mismanagement and breach of directors' and majority shareholders' fiduciary duty. This non-federal claim is couched in terms of a security fraud. Belco is alleged to have been the defrauded buyer in a security transaction when in July 1971 an open account indebtedness of some $300,000 resulting from loans by Belco to Bogue was formalized by Bogue's

issuance of a collateralized demand promissory note payable to Belco.

In May, 1972, the loans were fully repaid together with accrued interest at the rate of 8%. Zeller, claiming the loans were not made for any proper business purpose of Belco thereupon moved for summary judgment on the issue of liability. Petitioners cross-moved for summary judgment dismissing the complaint on the ground that with repayment of the loans Belco was recompensed for all recoverable out of pocket loss thereby mooting any federal securities laws claim. The District Court (per Gurfein, *J.*, Appendix B) dismissed the complaint, holding that under §28(a) of the 1934 Act the pre-*Erie* federal rule of fraud damages was applicable to the federal securities laws; and as Belco had been compensated for all out of pocket loss, it no longer had any claim under those laws. The Court of Appeals reversed and held (Appendix A) that a defrauded buyer may recover such non-out of pocket items of alleged damage as the following:

(a) gains prevented, including (1) any greater interest rate which Belco could have obtained by lending the money to others, (2) higher earnings which Belco might have made by investing the money in its own business and (3) proceeds of an allegedly lost underwriting which might have supplied Belco with additional capital funds.

(b) "disgorgement" of "profits" made by the alleged defrauder including (1) any increased interest which Bogue would have had to pay on a loan above the 8% actually paid to Belco, and (2) the alleged profit made by Bogue on the sale of the stock which collateralized the promissory note.

REASONS FOR GRANTING THE WRIT

POINT I

Certiorari should be granted in view of the clear conflict between the Second and Tenth Circuits as to the proper measure of a defrauded buyer's recoverable damages under the Federal Securities Laws.

Prior to the Court of Appeals' decision in this case, damages recoverable by an allegedly defrauded buyer under the anti-fraud provisions of the federal securities laws were consistently held to be measured by the out of pocket rule of fraud damages. The Tenth Circuit in *Estate Counselling Service, Inc.* v. *Merrill, Lynch, Pierce, Fenner & Smith,* 303 F.2d 527, 533 (1962) summarized the law as follows:

> "The failure to show actual damages is also a fatal defect in the cause of action based on the Securities Exchange Act of 1934, 15 U.S.C.A. §78a et seq. That Act permits recovery of 'his actual damages on account of the act complained of.' 'Actual damages,' under the Federal rule of damages for fraud is the 'out of pocket rule.' In the Federal courts the measure of damages recoverable by one who through fraud or misrepresentation has been induced to purchase bonds or corporate stock, is the difference between the contract price, or the price paid, and the real or actual value at the date of the sale, together with such outlays as are attributable to the defendant's conduct. Or in other words, the difference between the amount parted with and the value of the thing received. [citing cases]."

Following the *Estate Counselling* rule that a defrauded buyer-plaintiff is entitled to recover only "such moneys as plaintiff has paid out, with interest, and any other *outlay* legitimately attributable to defendant's fraudulent conduct * * *" (Ibid., *emphasis added*) are other Tenth Circuit decisions (see, *Esplin* v. *Hirschi*, 402 F.2d 94, 104 (1968) *cert. den.* 394 U.S. 928 (1969); *Richardson* v. *MacArthur*, 451 F.2d 35, 43 (1971), and the Ninth Circuit in *Sackett* v. *Beaman*, 399 F.2d 884, 891 (1968). The out of pocket rule for buyers has also been approved in dicta in other circuits (see, *Janigan* v. *Taylor*, 344 F.2d 781, 786 (1st Cir. 1965), *cert. den.* 382 U.S. 879 (1965); *Mysel* v. *Fields*, 386 F.2d 718, 745 (8th Cir. 1967), *cert. den.* 390 U.S. 951 (1968); *Kohler* v. *Kohler*, 208 F. Supp. 808 (E.D. Wisc. 1962), *aff'd* 319 F.2d 634 (7th Cir. 1963) and has even been specifically approved by the Second Circuit in its prior decisions (see, *S.E.C.* v. *Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1104 (1972); *Levine* v. *Seilon*, 439 F.2d 328, 334 (1971)).

By allowing an allegedly defrauded buyer to recover such non-out of pocket elements of purported damages as those listed above, the Court of Appeals has made a clear break from the foregoing authorities and has established a rule of law totally inconsistent with the Tenth Circuit's holdings.

POINT II

Certiorari should be granted as there is no logical basis upon which an expanded measure of damages can be sustained; any such expansion would be contrary to the prior holdings of this Court.

To justify its departure from the settled law the Court of Appeals referred to this Court's decision in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972) which approved the First Circuit's holding in *Janigan* v. *Taylor*, *supra*, that defrauded *sellers* are entitled not only to their out of pocket loss (i.e., the difference between the value of what they sold and what they got) but also any additional profits realized by the defrauding buyer (Appendix A, p. 11a). We respectfully submit that the Court of Appeals erred in not recognizing the essential difference between buyers and sellers, which difference of necessity precludes application of the seller's rule to buyers. That essential difference is the nature of the property parted with—the buyer parting with money while the seller parts with a property or commodity other than money.

In *Janigan*, *supra*, 344 F.2d at 786, where the seller's disgorgement rule was first established, Judge Aldrich was careful to draw a distinction between buyers' and sellers' remedies, holding with respect to defrauded sellers that:

> "future accretions not foreseeable at the time of the transfer even on the true facts, and hence speculative are subject to another factor, viz., that they accrued to the fraudulent party."

The seller's disgorgement theory thus is built upon two bases: (1) there are accretions to the property transferred; (2) restitutional principles of unjust enrichment. If applied to buyers it is readily apparent that one of these bases is absent and with that the disgorgement rule fails to apply. The buyer parts with money. There are no "accretions" to the money. Any profits accruing to the defrauder result from the *use* to which the fraudulently obtained money is put.* The seller, however, parts with property other than money, typically shares of stock or other security. As these properties generally have a fluctuating value, any "accretions" necessarily involve the increased value of the property itself; logically such profit should be disgorged as the defrauded seller would have had the benefit of those accretions but for the fraud. In *Janigan,* for example, the seller parted with shares of stock which increased in value after the fraudulent sale. It was this profit which but for the fraud would have accrued to the plaintiff who would still have had the security in his pocket when the increased value became available. In our case, as in any typical buyer's case, the alleged profits which plaintiff seeks to compel be "disgorged" have nothing whatsoever to do with the property (i.e., the money) parted with, and there is no way in which Belco would have had the benefit of those "profits" but for the fraud. The disgorgement theory, therefore, is not applicable and makes no sense when applied to a buyer, and the Court of Appeals erred in applying it.

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* In *S.E.C.* v. *Manor Nursing Centers, Inc., supra,* 458 F.2d at 1104 the Second Circuit recognizing the distinction between buyers and sellers specifically held that any profits or income resulting from a seller's use of money fraudulently obtained from a buyer could not be recovered under the disgorgement rationale.

Moreover, the disgorgement rule as applied to buyers runs afoul of this Court's holdings in the touchstone securities fraud cases of *Smith* v. *Bolles*, 132 U.S. 125 (1889), and *Sigafus* v. *Porter*, 179 U.S. 116 (1900). These cases established the pre-*Erie* federal rule of fraud damages for a buyer of securities. That rule, commonly referred to as the out of pocket rule, is summarized by this Court's words in *Bolles* where it held at 132 U.S. 129, "[w]hat plaintiff might have gained is not the question, but what he had lost by being deceived into the purchase," and in *Sigafus* where it held at 179 U.S. 123 that "the true measure of damages suffered" for fraud "is the difference between the actual value of that which he parts with and that which he receives under the contract. It is the loss which he sustained and not the profits which he might have made by the transaction."* The out of pocket rule for fraud damages enunciated in these cases (with the disgorgement rule engrafted for sellers) has universally been held to be the applicable rule for damages under the anti-fraud provisions of the federal securities laws (see authorities cited in Point I, *supra;* 2 Bromberg, *Securities Law, Fraud, S.E.C. Rule 10b-5,* §9.1). Each and every item of damage which plaintiff seeks to recover represents a non-out of pocket item and, hence, is not within the scope of recoverable fraud damages. Judge Friendly attempts to avoid this conclusion by classifying two items

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* The rationale of this Court's opinion in *Bolles* and *Sigafus* is approved by the Restaters, who have noted that:

> "Logically the out-of-pocket rule appears beyond argument to be the proper rule for a tort action, since the purpose of such action is to compensate for loss sustained, and restore the plaintiff to his former position, and not give him the benefit of any contract he may have made." Restatement of Torts 2d, Tent. Draft #11, §549 Note 4.

of alleged damage (the 40% return on capital which Beleo supposedly could have made by investing the loaned funds in its own business, and the $800,000 lost benefit of a proposed underwriting) as "consequential" damages which admittedly "are in addition to or in lieu of what ordinarily constitute a fair recovery" (Appendix A, p. 14a). Of course, these supposedly consequential damages are not out of pocket items but represent gains which Beleo allegedly was prevented from making. By allowing recovery of such gains prevented the Court of Appeals has, in effect, returned to the concededly rejected "benefit of the bargain" rule of fraud damages in that an allegedly defrauded buyer is not compensated merely for losses sustained but is given the benefits which would have accrued had there been no fraud.* The refusal of the Court of Appeals to follow the buyer's rule of damages set forth in *Bolles* and *Sigafus* should be corrected by this Court or this case will stand as an aberration in the well settled federal securities law.

POINT III

Certiorari should be granted because the decision of the Court of Appeals will result in the federal courts being deluged by state law claims.

In expanding the scope of recoverable damages for violation of Rule 10b-5, the decision of the Court of Appeals has changed that rule from an anti-fraud regulation to a substitute vehicle for what are properly state court cases

* None of the textwriters or authorities cited by the Court of Appeals (see Appendix A, p. 14a) in any way hint that in a business transaction lost profits are a proper element of consequential damages.

of corporate mismanagement and violation of fiduciary duty. The effect will be to open the doors of the federal courts, with nationwide jurisdiction, to any claim of corporate mismanagement touching upon the purchase or sale of a security.

State law bonding requirements will no longer serve as a deterrent to ill-founded claims of corporate mismanagement.

This very lawsuit is a prime example. The reality of the complaint is a charge of corporate mismanagement—interlocking directors improperly causing a subsidiary to make illegal loans to its parent corporation. The damages claimed are those which plaintiff would have claimed in a stockholder's derivative action in the courts of New Jersey, New York or Delaware. All of those states have stringent bond requirements. Yet, by attaching those claims to a claim of 10b-5 violation, plaintiff, a citizen and resident of Pennsylvania, has been able to sue in the Southern District of New York, a New Jersey corporation, a Delaware corporation and four citizens of New Jersey, none of which corporations or individuals are in New York, and the Court of Appeals has held that the damages which might be recovered in the courts of New Jersey, New York or Delaware for corporate mismanagement may be recovered in the federal court as damages for a 10b-5 violation and not merely under pendent jurisdiction of state court claims.

Neither the Congress, in enacting the securities laws, nor the Securities Exchange Commission in formulating Rule 10b-5 could have intended such a strange result. Under the decision by the Court of Appeals, §10(b) and Rule 10b-5 will cease to be anti-fraud securities regulations.

They will become corporation regulatory rules, under which the federal courts will be called upon to develop their own substantive federal corporation laws. This Court in *Superintendent of Insurance* v. *Bankers Life & Casualty*, 404 U.S. 6 (1971) did approve a limited application of 10b-5 to cases of corporate mismanagement, and in the *Ute* case, *supra*, it approved the disgorgement rule as applied to defrauded sellers. Whether to now stretch those two cases and say that the disgorgement rule should be applied to buyers together with the other rules of state law damages concerning corporate mismanagement and breach of fiduciary duty is a question of such great importance that it should be passed upon by this Court.

CONCLUSION

For the reasons given, petitioners pray that the writ be granted.

Respectfully submitted,

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